

## Concerns on practical feasibility and transparency

19 July 2017

### Purpose

1. The purpose of this note is to address Independent Processors' (IPs) concerns on:
  - 1.1 our assessment of practical feasibility for the purposes of the contestability dimension in our statutory annual reviews of Fonterra's milk price Manual (Manual) and milk price calculation (Calculation); and
  - 1.2 the transparency of Fonterra's Calculation.
2. We also explain our view of our role under the milk price monitoring regime (s 150A) in the Dairy Industry Restructuring Act 2001 (DIRA).

### Concerns on practical feasibility raised at the Workshop

3. At the Workshop held on 23 May 2017, IPs expressed concerns that we had given too much weight to theoretical feasibility in some aspects of our review of the Manual and the Calculation, and that feasibility has not been properly tested from a technical or more importantly real world perspective, including a commercial feasibility perspective.<sup>1</sup>
4. We agree that the test of practical feasibility under s 150A goes further than theoretical feasibility. Subject to the safe harbours in s 150B and the mandatory requirements in s 150C, we further agree that practical feasibility includes commercial feasibility in the sense that it must be reasonably possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed. In our view, this is how we have always interpreted practical feasibility – see, for example, our approach paper, where we outline what we consider as part of our assessment of practical feasibility.<sup>2</sup>

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<sup>1</sup> Open Country, Miraka and Synlait, *Commerce Commission Workshop: 23 May 2017, Agenda Item: Practical feasibility* (23 May 2017). For further details on the workshop, see: Commerce Commission, *Review of Fonterra's 2016/17 base milk price calculation: Workshop details* (30 May 2017).

<sup>2</sup> "This involves examining, wherever possible, whether the assumptions, inputs and processes reflect activities and achievable levels of performance based on evidence provided by Fonterra" and "where we are unable to conclude that Fonterra's notional average values are practically feasible or where average data has not been used, we rely on data from Fonterra's specific recently built plants. In these circumstances, if some part of Fonterra's business (such as a specific plant), is able to achieve those costs, an efficient processor (building an incremental plant) should be able to achieve them". Commerce Commission, *Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation* (15 September 2016), paras 75-77. We note that our recent Calculation reviews focused more on the feasibility of the components at an aggregated level (i.e. internal consistency of the model).

5. We note the table provided by Parker Business Services Limited (representing Miraka), outlining its view on how to assess practical feasibility.<sup>3</sup> While we have not presented the analysis in our reviews in the same format, we consider that we have generally used the same criteria it identified, with the exception of the gross values (but note that we sometimes express it differently).<sup>4</sup> However, we do not adopt all criteria for any given issue. For the purpose of illustrating this, we have provided examples in the table at Attachment A showing how our previous conclusions on the various dimensions of the milk price used the criteria for commercial feasibility identified by Parker Business Services. In the table, the ticks represent the criteria that we have considered for each component.
6. We have also provided comments in the table, with references back to previous reports, to demonstrate this point. Where we have not used a particular criterion we have left the cell in the table blank and identified which other practical feasibility criteria we have relied on. While we have not used all the criteria set out in the table, we consider that if we did, it would not alter our previous conclusions.
7. Consistent with our approach paper, we have looked at the achievability of the inputs, assumptions and processes at a plant level to assess demonstrable feasibility. We consider that Fonterra has demonstrated achievability if its average plant or a specific plant can achieve those costs (eg, a modern Fonterra plant such as Darfield). If those costs have been achievable by Fonterra, we have therefore been satisfied that these costs are also achievable for an efficient processor.
8. In our 2015/16 Calculation review, we looked at the components of the base milk price from a per unit (KgMS) perspective in our aggregate assessment comparison with Fonterra's Global Operations and Global Ingredients businesses manufacturing the reference commodity products (Fonterra's GOGI RCP operation).<sup>5</sup> Although there were some differences in unit costs, we were able to explain the differences as being due to the difference in plant specifications, logistics and operations. The aggregate assessment findings did not result in our considering any changes to our previous conclusions on the individual components.

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<sup>3</sup> Open Country, Miraka and Synlait, *Commerce Commission Workshop: 23 May 2017, Agenda Item: Practical feasibility* (23 May 2017), page 4.

<sup>4</sup> The criteria identified by Parker are technical feasibility, demonstrable feasibility and real world overlay (gross values and unit values). We do not consider it possible to compare gross values with another processor due to differences between the notional producer and other processors (in particular, Fonterra).

<sup>5</sup> We note that Miraka disagreed with our approach in assessing whether the notional producer was practically feasible as a whole. In our view, Fonterra's GOGI RCP operation is a comparable proxy to the notional producer.

9. We consider that the issues raised at the 23 May Workshop and in Appendix B of Miraka's submission on the 2016/17 Manual review have been previously resolved in our past reviews.<sup>6</sup> In the absence of any substantial new information, we have not reassessed issues on which we have already reached a concluded view.

*The use of safe harbours and mandatory assumptions in our assessment*

10. We consider that the safe harbour assumptions and mandatory principles stated in s 150B and s 150C define the key features of the notional producer. We note the IPs' view that some of the mandatory assumptions and safe harbours are not practically feasible.<sup>7</sup> Fonterra is allowed to use the safe harbour assumptions in s 150B, and is required to apply the principles in s 150C, in its Manual and Calculation. As these are respectively stated to "not detract from the purpose of s 150A" (s 150B) and to be "for the achievement of the purpose in s 150A" (s 150C), in our view they can be presumed to meet the purpose of s 150A, and therefore do not have to be assessed against the practical feasibility limb of s 150A.
11. The IPs' view is that there should be flexibility and discretion when applying the safe harbours. However, under DIRA, we cannot prescribe to Fonterra how to apply the safe harbours in the Calculation. If it chooses to apply the safe harbours to downstream assumptions, then we do not assess the practical feasibility of those assumptions so long as they are within the scope of the safe harbour.<sup>8</sup>

**Transparency**

12. It appears from the Workshop materials and comments that there are differing opinions on our role under the milk price monitoring regime; in particular, our role in promoting transparency to provide for greater contestability in the market for raw milk.
13. IPs have raised two separate issues on transparency:
- 13.1 there is not enough information available on certain aspects of Fonterra's milk price to provide proper input to the Commission's review process on practical feasibility; and
- 13.2 market participants face regulatory risk by not having access to timely milk price information throughout the season (i.e. milk price predictability).

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<sup>6</sup> Miraka, *Submission to the Commerce Commission Draft Report (14 October 2016): Review of Fonterra's 2016/17 Milk Price Manual* (14 October 2016).

<sup>7</sup> The example raised by Miraka is that it is not commercially feasible to produce a narrow range of products with the scale of the notional producer because the volume assumed is greater than the world market purchases. S 150C(2) states that the portfolio must be determined using Fonterra's most profitable commodities and that all milk collected must be used in producing those commodities so the issue is outside our remit under the legislation.

<sup>8</sup> Miraka, *Submission to Commerce Commission: Draft report Manual review, Appendix B* (15 October 2017).

*Not enough information on certain aspects of the milk price available to IPs*

14. We are required to review the extent to which Fonterra's Manual and Calculation are consistent with the purpose outlined in s 150A; namely, to 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 in New Zealand. In reaching our decision, the Act requires us to consult with Fonterra. In addition, we consider IPs can add an important perspective, so we have ensured that there have been numerous opportunities for the IPs to contribute to our processes. In particular, we have sought input on the issues we are considering in any given review. However, there is currently no provision in the Act that entitles IPs to specific information from Fonterra in order perform this role and the disclosure of Fonterra's information by us is a matter of our judgement based on whether and how disclosure would assist us in carrying out our statutory reviews.
15. While the Act does not give IPs the right to information, we will continue to encourage Fonterra to disclose information where we consider that there is a lack of transparency and where the information can assist with our reviews. But this must be balanced by Fonterra's right to protect propriety information.
16. We will address the transparency surrounding Fonterra's decision to include off-GDT sales in its calculation of WMP, SMP and AMF prices in our 2016/17 Calculation report.

*Regulatory risk faced by participants*

17. We note the arguments made by IPs about the regulatory risks faced by IPs and other market participants and the impact this has on the market. However, our role is limited to reviewing Fonterra's Manual for the current season and the Calculation for the past season. It is not our role, nor is it within our powers, to actively seek information that does not relate to our review process from Fonterra.<sup>9</sup> We also do not have an educative or advocacy function under DIRA. The regime was not established by us and we cannot amend it.
18. However, we recognise that disclosure of this information could promote efficiency and contestability of NZ dairy markets and we therefore continue to encourage Fonterra to release information that would reduce the regulatory risk faced by market participants. Based on IPs' previous submissions, we understand that the most useful information is sales phasing and exchange rate information. We also continue to encourage both IPs and Fonterra to engage with each other on this issue going forward.

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<sup>9</sup> For the purposes of the base milk price calculation review, s 150P states that we must report on the extent to which the assumptions adopted and the inputs and process used by Fonterra in calculating the base milk price for the season are consistent with the efficiency and contestability purposes in s 150A. This means our only function is to assess each component (assumptions, inputs, processes) of the base milk price for consistency with the efficiency and contestability purposes.

*Concluding remarks*

19. We reiterate that our role under DIRA is to review the extent to which Fonterra's Manual and Calculation are consistent with the s 150A purpose (i.e. consistent with the efficiency and contestability dimensions). The input that we seek from interested parties, including IPs, assists us in conducting our reviews.
20. We also recognise that DIRA never contemplated involvement by parties other than Fonterra in our review process. However, we have valued input from IPs and other parties throughout our reviews and will continue to provide opportunities for IPs to engage with us on issues which we consider outstanding.

Attachment A

		Commercial feasibility						
					Real world overlay			
	Milk price components	Technical feasibility (i.e. The notional producer model must make technical assumptions that are practically feasible on an operational level)	Demonstrable feasibility (i.e. at a plant level if applicable)	Gross values (total value of component)  Note: It is not comparable at a component level due to the differences between the notional producer and Fonterra or any other processor. The notional producer assumes to produce more RCPs than any other NZ processor, including Fonterra.	Unit values (Kg/MS)	Additional comments on real world overlay	Mandatory principles/ safe harbour assumptions	Drive Fonterra efficiency (i.e. any notional values would give an incentive for Fonterra to act efficiently. These can be actual values from previous years (independent from current performance))
Ability to transfer commodity price risk	WACC (asset beta)	✓	✓				✓	✓
			Allocation of risks: Commodity price risk passed onto the farmer suppliers is demonstrable. There is evidence that processors such as Murray Goulburn and Synlait pass commodity price risk to its farmers.  The issue of what is a reliable numerical estimate of the asset beta to reflect that the notional producer is exposed to little risks as a result of the mandatory and safe harbour assumptions will be addressed in our 2016/17 calculation report.				s 150C(1)(a): The actual prices achieved by Fonterra on commodities goes into milk price. The risk of changes in commodity prices also goes into milk price.	Para 4.39, 2015/16 calculation report.

Sales revenue	Pricing	✓	✓		✓		✓	✓
		Based predominately on GDT prices and sold on GDT (paras 7.125 - 7.135 2014/15 calculation review).	Pricing is based on Fonterra's actual prices achieved for sales of RCPs (paras 7.113 - 7.117 2014/15 calculation report).		Uses published GDT prices.  No issue with how prices are calculated in the model (process of taking GDT disclosed prices and turning into notional producer's prices). (refer to para F9-F10, page 88, 2013/14 calculation review).		s 150C(1)(a): The actual prices achieved by Fonterra on commodities.	Para 7.120 - 7.124, 2014/15 calculation report.
	Production plan		✓				✓	✓
		Mandatory assumption that the milk price notional producer produces Fonterra's most profitable commodities using Fonterra's actual milk collected.	Production plan based on actual data (paras 7.5 - 7.9 2014/15 calculation report).				s 150C: Product mix based on Fonterra's most profitable commodity products using all of Fonterra's milk.  s 150B(d): Milk supply.	Para 7.14 - 7.18, 2014/15 calculation report.
	Sales phasing	✓	✓					✓

		paras 7.107 - 7.109 2014/15 calculation report.	Sales phasing based on Fonterra's sales phasing for RCPs (paras 7.96 - 7.98 of 2014/15 calculation report).					Para 7.102, 2014/15 calculation report.
Sales commission	Selling costs	✓	✓		✓		✓	
		Paras 8.175, 8.181 - 8.193, 2014/15 calculation report.  Paras 4.106 - 4.110, 2015/16 calculation report.	Paras 8.175, 2014/15 calculation report.		See aggregate assessment: comparison with Fonterra's GOGI RCP operation. Refer to paras 4.2 - 4.33, 2015/16 calculation report).		Para 8.179 - 8.180, 2014/15 calculation report.	

<b>Cost rates - corporate costs</b>	Administration costs							
	Other supply chain costs							
	Plant labour							
	Site overhead costs	✓	✓		✓			✓

	<p>Fonterra has made technical assumptions using its own business what adjustments would need to be made to get to the notional producer's business structure. A sizable 'bottom up' exercise was done in 2015/16. We comprehensively reviewed these assumptions in our 2015/16 calculation review.</p>	<p>Administration costs: (Paras 4.99-4.101, 2015/16 calculation report) We did note that in absence of any comparable data from other processors, we considered that the approach taken was appropriate.</p> <p>Other supply chain costs: (Paras 4.99-4.101, 2015/16 calculation report).</p> <p>Plant labour (Paras 4.99-4.101, 2015/16 calculation report).</p> <p>Site overhead costs (Paras 4.99-4.101, 2015/16 calculation report).</p>		<p>See aggregate assessment: comparison with Fonterra's GOGI RCP operation. Refer to paras 4.2 - 4.33, 2015/16 calculation report).</p>	<p>Comparison with real world business: We have compared and identified the differences between GOGI (formerly NZMP) and the notional producer. (para 5.38 - 5.41, 2014/15 calculation review and para 4.2 - 4.33, 2015/16 calculation report)</p> <p>We could explain the cost differences and were satisfied that this did not result in any milk price components being not practically (commercially) feasible.</p> <p>We note that we disagreed with Miraka's view that the notional producer is not comparable with GOGI. We consider GOGI RCP's business is a good proxy for the notional producer (para 4.25 - 4.27, 2015/16 calculation report).</p>		<p>Based on 2014/15 Fonterra budgeted figures and scaled to reflect the operational requirements of the notional business (para 4.100, 2015/16 calculation report).</p>
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<b>Cost rates: other operating costs</b>	Collection costs						
	Water/cleaning and lab costs						
	Packaging	✓	✓		✓		✓
	Storage						
	Lactose costs						
	Energy costs						
	Freight costs						
	Other supply chain costs	Fonterra has made technical assumptions that we consider commercially feasible from looking at Fonterra's plant specifications with the notional producer's standard plant specifications. See our practical feasibility assessments for these components in 2014/15 calculation report.	Collection costs: (paras 8.25, 8.35 - 8.41, 2014/15 calculation report) Water/cleaning and lab costs: (paras 8.68, 8.70, 8.81,8.82, 2014/15 calculation report) Packaging: (paras 8.107 - 8.109, 8.114, 2014/15 calculation report) Storage: (paras 8.144, 8.145, 2014/15 calculation report) Lactose costs: (paras 7.90-7.92, 2014/15 calculation report) Energy costs: (Paras 8.14 - 8.20, 2014/15 calculation report) See also Strata energy consulting report: <a href="http://www.comcom.govt.nz/dmsdocument/13562">http://www.comcom.govt.nz/dmsdocument/13562</a> Freight costs: (Paras 8.154 - 8.156, 2014/15 calculation report) Tax: (Paras 9.13 - 9.21, 2014/15 calculation report).		See aggregate assessment: comparison with Fonterra's GOGI RCP operation. Refer to paras 4.2 - 4.33, 2015/16 calculation report).	Regional cost allowances in model (table 5.1, page 40, 2014/15 calculation review report).	
	Tax						

<b>Cost rates: Capital costs</b>	Fixed assets	✓	✓				✓	✓
	Depreciation (tilted annuity methodology)							
	Repairs and Maintenance	We identified that some assumptions are probably not technically feasible such as upgrading old plants to latest technology. However, we are satisfied that the approach taken by Fonterra results in a higher CAPEX spend than alternative approaches. (see para 4.126 - 4.128 2015/16 calculation report).	Capital costs (paras 6.58 - 6.64, 2014/15 calculation review).  Depreciation (tilted annuity methodology) (paras 6.72 - 6.74, 2014/15 calculation review).  Repairs and Maintenance (paras 6.87 - 6.91, 2014/15 calculation review).  Consistency amongst the components (paras 4.112 - 4.135, 2015/16 calculation review).				s 150B(a): national network of facilities  s 150B(b): size of processing capacity	Capital costs (paras 6.56 – 6.57) Depreciation (paras 6.71) Repairs and Maintenance (paras 6.86).
<b>Yields/ plant operating efficiency</b>	Yields Capacity	✓	✓				✓	✓

	<p>Greg Winter (our independent expert) confirmed that assumptions for yields are practically feasible, therefore the technical assumptions for the notional producer must be feasible. Paras 4.70 - 4.97, 2015/16 calculation report.</p> <p>We had previously looked at the plant efficiency assumptions. Paras A5.28 - A5.44, page 58, Report on the dry run review of Fonterra's farm gate milk price.</p> <p>Plant capacity: paras 5.85 – 5.106, 2014/15 calculation report.</p>	<p>Fonterra has provided evidence that the losses and specification offsets can be achieved from actual past Fonterra data. Paras 4.79, 4.86, 2015/16 calculation report, Paras 7.36 - 7.41, 2014/15 calculation report.</p> <p>We did recommend that Fonterra obtain a more robust set of loss data particularly in different points in the season (para 4.76, 2015/16 milk price calculation).</p> <p>On product time (OPT) assumption: paras 5.94 - 5.98, 2014/15 calculation report.</p>			<p>Our independent expert (Greg Winter) completed a comprehensive review of the yields. In his review, he considered the commercial realities of losses on the following points in the 2015/16 report (para 477, 2015/16 calculation report).</p> <p>We note that Greg Winter met with Fonterra's independent expert to discuss concerns he had on the feasibility of the yields. He considered that his concerns were addressed (para 4.72.4, page 29, 2015/16 calculation report).</p> <p>Based on Greg Winter's assessment, we are comfortable that commercial considerations have been factored in the yields assumptions. e.g. plant operating efficiency throughout season, downtime, variable losses incurred throughout season.</p> <p>Plant operating efficiency: Standard plant configuration realities (para 5.87 to 5.106, page 50, 2014/15 calculation review report), A5.28 - A5.44, Report on the dry run review of Fonterra's farm gate milk price.</p>	<p>s 150B(d): all milk collected is processed into commodities at yields that are practically feasible.</p>	<p>paras 7.44 - 7.46, 2014/15 calculation report.</p>
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<b>Changes to product portfolio</b>	Production plan	✓	✓				✓	N/A
		<p>We clarify that the change would not be made instantaneous.</p> <p>Fonterra has noted to us that it would take 12-18 months for a processor to change its plants, depending on the product change (i.e. less time to change existing plants to retrofit new product line than completely rebuilding plants). This is consistent of the Milk Price model evolving in a manner consistent with the evolution of a 'real world' dairy processor.</p>	<p>Asset stranding risk incorporated in milk price Para 4.59 - 4.65, 2015/16 milk price calculation.</p>				<p>s 150C: Fonterra must use its most profitable commodities in the milk price portfolio.</p>	
<b>USD/NZD Conversion rate</b>	Foreign exchange	✓	✓				✓	
			<p>Paras G12 - G16, page 79, 2012/13 milk price calculation report. We address the difference between Fonterra and the notional producer's exchange rate.</p>				<p>s 150B(c): Gains and losses from foreign exchange hedging included in milk price</p>	<p>Safe harbour s 150B(c )</p>